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Person To Contact: _____, ID No. _____

Telephone Number: _____

Refer Reply To:
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Date:
October 09, 2015

TY:

Organization =
City =
LLC =
X =
Y =
Z =
Investor Member =
Special Member =

Dear _____:

This is in response to Organization's letter dated July 10, 2014, in which Organization requested certain rulings with respect to §§ 501(c)(3), 512, and 4943 of the Internal Revenue Code.

FACTS

Organization is an exempt organization described in § 501(c)(3) and classified as a private foundation under § 509(a). Organization's purpose is to directly or indirectly build, develop, finance, purchase, rehabilitate, own, sell, and operate affordable housing in City for persons of low and moderate income including but not limited to elderly persons with a need for housing, health care, financial security, and assisted living only to the extent assistance of such persons is deemed to be charitable under § 501(c)(3). Organization has an investment in and is a managing member of LLC. LLC operates an affordable low-income housing project for the elderly (Project) which has qualified for and been allocated low income housing credits pursuant to § 42. Operation of the Project is LLC's only activity.

As managing member, Organization has control over LLC sufficient to ensure that the operation of the Project furthers charitable purposes within the meaning of § 501(c)(3). Organization generally has no revenue other than interest income derived exclusively from interest earned on Organization's cash balances, though on occasion Organization receive grants which Organization uses for the operations and maintenance of the Project.

LLC is currently a multi-member LLC taxed as a partnership reporting income from a single low-income housing project. Organization currently owns x percent of LLC. LLC's other members are Investor Member, a limited partnership that owns y percent of LLC, and Special Member, a corporation that owns x percent of LLC and is the general partner of Investor Member. None of Organization's current or former trustees, directors, officers, key employees, or contributors has any financial interests in or business relationships with Investor Member or Special Member, either directly or indirectly through one or more intermediary entities. Additionally, neither Special Member nor Investor Member has contributed more than \$5,000 or more than two percent of the total contributions to Organization.

Organization has received offers from Investor Member and Special Member, in accordance with an option and right of first refusal agreement, to purchase the membership interests of Investor Member and Special Member for \$z. Organization represents that \$z is less than the fair market value of Investor Member's and Special Member's membership interests based on a recent appraisal of the property by an outside appraiser. Exercise of the option and right-of-first-refusal by Organization to buy out the Investor Member and Special Member's membership interests would result in Organization owning 100 percent of LLC and LLC's being disregarded as separate from Organization for federal tax purposes. Except for a de minimis amount, Organization's income after the purchase will be from Organization's interest income and rental payments from those living in the low-income housing.

Organization represents the following with respect to Project's operations both before and after Organization's proposed purchase of Investor Member and Special Member's membership interests. The Project has had and will continue to have (a) at least 75 percent of the units occupied by residents that qualify as low-income: and (b) either at least 20 percent of the units are occupied by residents that also meet the very low-income limit for the area or 40 percent of the units are occupied by residents that also do not exceed 120 percent of the area's very low-income limit. The Project is and will continue to be actually occupied by poor and distressed residents. The Project's housing is and will continue to be affordable to the Project's low-income and very low-income residents. Finally, the facility owned by LLC consists of only one building.

RULINGS REQUESTED

The following rulings have been requested:

1. The Project, the low income housing project run by the LLC, the activities of which will be attributed to Organization, meets the safe harbor found in Rev. Proc. 96-32 and will continue to do so after Organization's acquisition of all of the membership interests in LLC, therefore these activities will further the charitable purpose of relieving the poor and distressed under section 501(c)(3), and the regulations thereunder.
2. Organization's acquisition of additional membership interests in LLC, resulting in Organization's owning 100 percent of LLC, will not subject Organization to excess business holdings tax under § 4943.
3. The rental income Organization derives from LLC after Organization's acquisition of additional membership interests in LLC, resulting in Organization's owning 100 percent of LLC, will not constitute unrelated business income subject to unrelated business income tax.
4. Organization's acquisition of additional membership interests in LLC resulting in Organization's owning 100 percent of LLC, will not constitute a recapture event under § 42(j) for the low-income housing tax credit allocable to LLC.

LAW & ANALYSIS

Section 501(a) of the Code exempts from federal income tax organizations described in § 501(c).

Section 501(c)(3) of the Code describes organizations organized and operated exclusively for charitable and other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 509(a) of the Code provides that a private foundation is an organization described in § 501(c)(3) other than an organization described in section 509(a)(1), 509(a)(2), 509(a)(3), or 509(a)(4).

Section 511(a)(1) of the Code imposes a tax for each taxable year on the unrelated business taxable income of every organization described in section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means the gross income derived by an organization from an unrelated trade or business (as defined in § 513) regularly carried on by it, less the deductions allowed for expenses directly connected with the carrying on of such trade or business.

Section 512(b)(3)(A)(i) of the Code excludes from unrelated business taxable income all rents from real property.

Section 512(b)(4) of the Code provides that notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in § 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under § 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under § 514(a)(2).

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall include its share of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need for income or funds or the use it makes of the profits derived) to the exercise of performance by such organization of its charitable, educational, or other purpose constituting the basis for its exemption under § 501.

Section 514(a) of the Code provides that, "In computing under § 512 the unrelated business taxable income for any taxable year there shall be included with respect to each debt-financed property as an item of gross income derived from an unrelated trade or business an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as (A) the average acquisition indebtedness (as defined in subsection (c)(7)) for the taxable year with respect to the property is of (B) the average amount (determined under regulations prescribed by the Secretary) of the adjusted basis of such property during the period it is held by the organization during such taxable year."

Section 514(b) of the Code provide that, "For purposes of this section, the term 'debt-financed property' means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition), except that such term does not include any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption."

Section 4942(j)(4) of the Code defines a "functionally related business" as a trade or business which is not an unrelated trade or business as defined in § 513.

Section 4943(a) of the Code imposes a tax on the excess business holdings of any private foundation in a business enterprise during any taxable year which ends during the taxable period a tax equal to 10 percent of the value of such holdings.

Section 4943(c)(1) of the Code provides that the term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

Section 4943(c)(2)(A) of the Code provides that the "permitted holdings" of any private foundation in an incorporated business enterprise are 20 percent of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons.

Section 4943(c)(2)(B) of the Code provides that "permitted holdings" in a corporation, where one or more persons who are not disqualified persons with respect to the private foundation have effective control, are not more than 35 percent of the voting stock held by the private foundation and all of its disqualified persons.

Section 4943(c)(3) of the Code provides that "permitted holdings" of a private foundation in a business enterprise which is not incorporated shall be consistent with § 4943(c)(2), except that (A) in the case of a partnership, "profits interest" shall be substituted for "voting stock" and "capital interest" shall be substituted for "nonvoting stock"; (B) in the case of a proprietorship, there shall be no permitted holdings, and (C) in any other case, "beneficial interest" shall be substituted for "voting stock ."

Section 4943(d)(3)(A) of the Code provides that, for purposes of § 4943, the term "business enterprise" does not include a "functionally related business" as defined in § 4942(j)(4).

Section 4943(d)(3)(B) of the Code provides that, for purposes of § 4943, the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. For purposes of subparagraph (B), gross income from passive sources includes the items excluded by §§ 512(b)(1), (2), (3), and (5).

Section 4946 of the Code defines "disqualified persons" with respect to a private foundation as substantial contributors, foundation managers, 20% owners of a substantial contributor, family members of an individual who is one of the above, entities 35% owned by one of the above, and certain government officials.

Section 1.501(c)(3)-1(d)(1)(i) of the Income Tax Regulations (Regulations) includes "charitable" among the list of purposes for which an organization described in section 501(c)(3) may be organized and operated.

Section 1.501(c)(3)-1(d)(2) of the Regulations provides that the term "charitable" is used in section 501(c)(3) in its generally accepted legal sense, and includes relief of the poor and distressed.

Section 1.501(c)(3)-1(e)(1) of the Regulations provides that an organization may meet the requirements of section 501(c)(3), although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in section 513.

Section 1.513-1(a) of the Regulations provides that, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the Regulations defines trade or business for purposes of § 513 as having the same meaning it has in § 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(d)(2) of the Regulations provide that a trade or business is related in the relevant sense only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and it is substantially related only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Section 53.4942(a)-2(c)(3)(iii) of the Regulations defines functionally related business as a trade or business which is not an unrelated trade or business as defined in § 513 or an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

Section 53.4943-10(a)(1) of the Regulations provides generally that the term "business enterprise" includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the

performance of services and which constitutes an unrelated trade or business under § 513.

Section 53.4943-10(b) of the Regulations provides that the term "business enterprise" does not include a functionally related business as defined in § 4942(j)(5).

Section 53.4943-10(c) of the Regulations provides that the term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources. For these purposes, gross income from passive sources includes the items excluded by sections 512(b)(1) (relating to dividends, interest, and annuities) and 512(b)(3) (relating to rent) and that any income classified as passive for these purposes does not lose its character merely because section 514 (relating to unrelated debt-financed income) applies to such income.

Section 53.4943-10(e) of the Regulations provides that for purposes of § 4943 and the regulations thereunder, the term "sole proprietorship" means any business enterprise

- (1) Which is actually and directly owned by a private foundation,
- (2) In which the foundation has a 100 percent equity interest, and
- (3) Which is not held by a corporation, trust, or other business entity for such foundation.

A foundation may be considered to own a sole proprietorship even though the foundation is itself a corporation or a trust. However, a sole proprietorship which is owned by a foundation shall cease to be treated as a sole proprietorship when the foundation no longer has a 100 percent interest in the equity of the business enterprise. Thus, if and when a foundation sells a 10 percent interest in a sole proprietorship, such business enterprise shall be treated as a partnership under section 4943 and the regulations thereunder.

Announcement 99-102, 1999-2 C.B. 545, discussing final regulations under § 7701, establishes that a limited liability company wholly owned by a single organization exempt under § 501(a) may be disregarded as an entity separate from its owner. When an entity is disregarded as separate from its owner, its operations are treated as a branch or division of its owner. Therefore, an owner that is exempt under § 501(a) must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return.

Rev. Proc. 96-32, 1996-1 C.B. 717, sets forth a safe harbor under which organizations that provide low-income housing will be considered charitable as described in § 501(c)(3) of the Internal Revenue Code because they relieve the poor and distressed as described in § 1.501(c)(3)-1(d)(2) if they meet the following conditions:

- (1) The organization establishes for each project that (a) at least 75 percent of the units are occupied by residents that qualify as low-income: and (b) either at least

20 percent of the units are occupied by residents that also meet the very low-income limit for the area or 40 percent of the units are occupied by residents that also do not exceed 120 percent of the area's very low-income limit;

- (2) The project is actually occupied by poor and distressed residents; and
- (3) The housing is affordable to the charitable beneficiaries.
- (4) If a project consists of multiple buildings and each building does not separately meet the requirements of (1), (2), and (3), then the buildings must share the same grounds.

Rev. Rul. 74-197, 1974-1 C.B. 143, provides that the investment by an exempt employees' trust in a partnership that was organized to invest in securities and borrows funds for that purpose may result in unrelated business taxable income to the extent its share of partnership income is derived from or on account of the debt-financed securities.

LLC is currently a multi-member LLC that is taxed as a partnership. Organization plans to acquire all of the membership interests and become the sole owner of LLC. Generally, a business entity that has a single owner and is not a corporation under § 301.7701-2(b) is disregarded for federal tax purposes as an entity separate from its owner (disregarded entity). See § 301.7701-2(c)(2)(i). Section 301.7701-2(a) provides that "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." A U.S. charity that wholly owns a disregarded entity must treat the operations and finances of the disregarded entity as its own for tax and information reporting purposes. See Ann. 99-102, 1999-2 C.B. 545. After Organization acquires all of the membership interests and sole ownership of LLC, LLC will be treated as a disregarded entity of Organization for federal tax purposes. Thus the low-income housing activity will be treated wholly as Organization's activity.

None of Organization's current or former trustees, directors, officers, key employees, or contributors has any financial interests in or business relationships with Investor Member or Special Member, either directly or indirectly through one or more intermediary entities. Additionally, neither Special Member nor Investor Member has contributed more than \$5,000 or more than two percent of the total contributions to Organization. Given that there is no financial interest as between Organization or Organization's officers and directors and Special Member or Investor Member, and since neither is a substantial contributor to Organization, Special Member and Investor Member are not disqualified persons as to Organization. Section 4946.

Rev. Proc. 96-32, supra, sets out a safe harbor for organizations that provide low-income housing under which a low-income housing project will be considered to further charitable purposes within the meaning for § 501(c)(3) by relieving the poor and distressed. From the facts and representations presented, the Project run by LLC, the activities of which will be attributed to Organization, meets the safe harbor found in Rev. Proc. 96-32, supra, and will continue to do so after Organization acquires all of the

membership interests in LLC. Since the Project has met and will continue to meet the safe-harbor found in Rev. Proc. 96-32, it furthers a charitable purpose described in § 501(c)(3) that is substantially similar to the purpose for which Organization were given exemption: the relief of the poor and distressed through the provision of low-income housing.

The mere fact that an organization engages in a trade or business activity does not necessarily jeopardize its exempt status. Section 1.501(c)(3)-1(e)(1). An organization may be subject to unrelated business income tax if the activity is regularly carried on and is not substantially related to the organization's exempt purpose. To be substantially related to an organization's exempt purpose, the activity must contribute importantly and bear a substantial causal relationship to the achievement of exempt purposes. Section 1.513-1(d)(2). LLC will be a disregarded entity and its activities will be attributed to Organization. Since the facts and representations show that the Project run by LLC will meet the safe harbor of Rev. Proc. 96-32, it will contribute importantly to Organization's charitable purposes to relieve the poor and distressed. Thus, it is not an unrelated trade or business under § 513(a).

In addition, under § 512(b)(3) the rental income Organization receives from the tenants in LLC's building are excluded from unrelated business income, except that such building was debt financed as described in § 514. Section 512(b)(4). Section 514(b) provides, however, that "debt-financed property" does not include any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. As described above, the operation of LLC's property substantially furthers Organization's exempt purpose through its role as low-income housing, therefore rental income derived from that property does not constitute unrelated business income.

Section 4943(a) imposes a tax equal to 10 percent of the value of any excess business holdings of a private foundation in a business enterprise during any taxable year which ends during the taxable period. Organization plans to own 100 percent of LLC, which operates the Project. Organization will own it as a sole proprietorship. A private foundation generally cannot operate a business enterprise as a sole proprietorship, other than a functionally-related enterprise or a business otherwise exempt, as a sole proprietorship. Section 4943(c)(3)(B); Treas. Reg. § 53.4943-3(c)(3). However, § 4943(d)(3)(A) provides that a "business enterprise" does not include a "functionally related business" as defined in § 4942(j)(4). Section 4942(j)(4) defines a "functionally related business" as a trade or business which is not an unrelated trade or business as defined in § 513. Since the facts and representations show that Project meets the safe harbor found in Rev. Proc. 96-32, LLC's operation of the Project, which is LLC's sole activity, is substantially related to Organization's exempt purpose. Since LLC's operation of the Project is substantially related to Organization's exempt purpose, such operation is not an unrelated trade or business as defined in § 513. Section 1.513-

1(d)(2). Accordingly, the Project is a functionally related business and therefore not a business enterprise for purposes of section 4943. In addition, the term "business enterprise" does not include a trade or business that derives at least 95 percent of its gross income from passive sources. Interest income and rents from real property are identified as "passive sources" under Treas. Reg. § 53.4943-10(c). Except for a de minimis amount, Organization's income will be from interest and rents from real property. Accordingly, Organization's sole ownership of LLC will not subject Organization to excise taxes on excess business holdings under § 4943.

CONCLUSION

In light of the foregoing, we rule as follows:

1. The Project, the low income housing project, run by the LLC, the activities of which will be attributed to Organization, meets the safe harbor found in Rev. Proc. 96-32 and will continue to do so after Organization's acquisition of all of the membership interests in LLC, therefore these activities will further the charitable purpose of relieving the poor and distressed under section 501(c)(3), and the regulations thereunder.
2. Organization's acquisition of additional membership interests in LLC, resulting in Organization's owning 100 percent of LLC, will not subject Organization to excess business holdings tax under § 4943.
3. The rental income Organization derives from LLC after Organization's acquisition of additional membership interests in LLC, resulting in Organization's owning 100 percent of LLC, will not constitute unrelated business income subject to unrelated business income tax.
4. We decline to rule on whether the acquisition of additional membership interests in LLC results in a recapture event under § 42(j). See Rev. Proc. 2015-1, § 6.11, 2015-1 I.R.B. 1, 17.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437. This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

No ruling is granted as to whether Organization qualifies as an organization described in § 501(c), and except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

Mary Jo Salins
Acting Branch Chief, Branch 1
(Tax Exempt & Government Entities)

cc: